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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 894

EDWARD H. WEITZEN, STANLEY R. GRANT, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Petitioners,

—against—

CHARLES HEIT, WALTER V. TYMINSKI and MARVIN J. LEVY,

Respondents.

EDWARD H. WEITZEN, STANLEY R. GRANT, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Petitioners,

—against—

BETTY VOLK, WALTER V. TYMINSKI and MARVIN J. LEVY,

Respondents.

STANLEY R. GRANT, LYBRAND, ROSS BROS. & MONTGOMERY, a partnership, CARL M. LOEB, RHOADES & CO., a partnership, and BELOCK INSTRUMENT CORPORATION,

Petitioners,

—against—

HELEN HOWARD and WALTER V. TYMINSKI,

Respondents.

PETITIONERS' REPLY TO MEMORANDUM FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION

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Petitioners respectfully submit this memorandum in reply to the memorandum submitted by the Solicitor General for the United States and the Securities and Exchange Commission.

Section 10(b) of the Securities Exchange Act and Rule 10b-5 have recently become the focal point of a multitude of private class actions for monetary damages in the district courts—to the practical exclusion of the other provisions of the Federal Securities Acts and of developing common law principles. They constitute "one of the most important and elusive provisions of the securities laws." *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 470 (opinion of Mr. Justice Harlan).

The Solicitor General's memorandum recognizes that this petition squarely raises an important question of interpretation under Section 10(b) and Rule 10b-5 which, if the decision below stands, will give rise to "troublesome problems" (Memorandum of Solicitor General, p. 7). It also points out that that question is not necessarily reached in the petition for certiorari filed in *Securities and Exchange Commission* v. *Great American Industries, Inc.* (No. 1195) and was not presented by the recently denied petitions in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.* (Nos. 897 and 937) (neither of which, of course, involved private damage actions). (*Id.* pp. 4n, 7n)

Nevertheless, the Solicitor General urges this Court to deny review here because he believes the decision below to be "correct" and because no other court of appeals has ruled on the question (*Id.*, p. 7). The latter point, given the fact that Rule 10b-5 was adopted in 1942 (Section 10(b) not being self-operative), merely serves to demonstrate that the result reached below represents an unprecedented expansion of the Act to encompass causes of action never until recently asserted in any court.

In trying to justify the alleged "correctness" of the decision below, the Solicitor General's memorandum attempts

to reframe the question presented by the petition. The express requirement of both Section 10(b) and Rule 10b-5 that the forbidden manipulative or deceptive device be used or employed "in connection with the purchase or sale" of a security is equated with a requirement simply that the corporate and individual defendants, not themselves purchasers or sellers, be responsible (whether by omission or commission) for information "reasonably likely to influence the investing public" (*Id.*, p. 5) or "reasonably likely to affect the market" (*Id.*, p. 10).

Further, the question sought to be framed by the Solicitor General's memorandum is in terms of the effectiveness of the prohibitions of "the securities laws" (*Id.*, p. 5), not the Section and Rule which are in issue. The suggestion is that if this Court considers the question presented, and agrees with petitioners, effective enforcement of the securities laws will come to an end. To color the issue in this fashion is, we submit, to concede its significance.

Despite such suggestions to which the Solicitor General's memorandum is largely devoted, the question posed by the petition does not intrude upon the powers of the Securities and Exchange Commission to insure adequate disclosure under the Securities Exchange Act and the other legislation it administers. The recently issued Report of the Commission's Special Study Group under the direction of Commissioner Wheat, *Disclosure to Investors, A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts,* concludes that presently available procedures are adequate for the purpose. For example, particular mention is made in the Report of the efficacy of the trading suspension procedure, which the Solicitor General's memorandum discounts, and of Section 15(c)(4)

of the Securities Exchange Act (enacted in 1964) which permits the Commission to issue orders requiring adequate reporting.

We submit that the alleged "correctness" of the decision below is belied by the "troublesome problems" it concededly gives rise to. These actions are private actions brought solely to collect damages. The financial statements involved here are not unusual. They are balance sheets and income statements—the prompt publication of which is urged by the stock exchanges and the Commission—of a going concern. They were not prepared in connection with any offering of securities and were not used by any defendant or by anyone connected with any defendant to effectuate offers or sales of securities. As it happened, certain of the company's executives, not the petitioners, had embarked upon a scheme to defraud the government in the costing of defense contracts, not to commit fraud in any securities transaction. The complaint is based solely on the alleged failure of the company's financial statements to reveal the frauds or the contingent liabilities.*

Similar allegations with respect to financial statements could be made had a corporate president been embezzling from the corporation and covering his tracks so that the financials failed to reflect this. The same would be true of any contingent liability of a corporation (totally un-

* The Solicitor General's memorandum (p. 13) states that the Belock financials in question here contained "affirmatively false figures" and false representations with respect to Belock's "liability for renegotiations". The fact is that the financial statements were erroneous only to the extent that they failed to reflect prior fraud on the government and the claims that the government would have against Belock as a result thereof. Obviously, there was no "affirmative representation" as to whether or not the company had defrauded the government.

related to any securities transaction) which was not specified in the corporation's financial statements. In any such situation the effect of disclosure on the aggregate market price of the corporation's stock (which would depend in large part on psychological and other intangible factors) would bear no necessary relationship to the actual amount of the corporation's loss.

To subject the corporations, their officers, directors and accountants (or, one might add as an example, financial journals which report their affairs, *cf.* 3 Loss *Securities Regulations* (2d ed. 1961), 1791 n. 362), *none of whom were engaged in any purchase or sale of securities,* to potential damage liability of staggering, albeit unpredictable, dimension in favor of securities traders in such situations does, indeed, pose "troublesome problems"—problems which may not be present in an action by the Commission or others for equitable relief where a lesser showing may be justified in establishing a 10(b) cause of action.* We submit that the proper procedure is not to establish a holding that liability for monetary damages exists on the part of such persons and then wrestle with the problems that holding creates, but to consider at the outset whether or not, in view of the very great problems which would be created, such a rule is correct and required by the Act and by Rule 10b-5.

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* *Cf. SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963) ("It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.") The decision below is based upon the interpretation by Judge Medina of the opinion of Judge Waterman (for himself and three other judges of the nine active judges of the Second Circuit) in the en banc decision in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833—a suit in equity by the Commission.

Dozens, if not hundreds, of damage actions have recently been filed and are pending in the district courts which, as to defendants who did not themselves purchase or sell securities, stand or fall on the question here presented for review. Unlike those actions which the Commission is expressly authorized to bring by Section 21 of the Act in performance of its administrative functions, where there is no question of standing to sue, these are actions brought by private parties solely to collect damages. They are premised upon an implied right of action which has been derived by lower courts from Section 10(b) and Rule 10b-5 in situations where the defendants were themselves buyers or sellers of securities, or participants in a securities transaction.* These actions purport to be brought on behalf of large classes of security holders supposedly similarly situated and represented by the nominal plaintiffs. Typically the complaints seek to state a claim on behalf of all those who during long periods of time bought or sold securities which are often heavily traded and for many and undecipherable reasons rapidly fluctuating in price. They assert claims for many hundreds of millions of dollars, indeed very likely billions of dollars, for which publicly traded companies, directors, salaried executives and professional firms are asked to respond.

These cases, like this one, allege that defendant corporations, officers, directors and auditors "knew or should have

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* As pointed out in the Solicitor General's memorandum (p. 6n), this Court has never expressly decided whether such an action may be implied and *a fortiori* either the substantive standards of liability to be applied or such concomitant procedural questions as the applicable statute of limitations. In *SEC* v. *National Securities, Inc., supra,* an action by the Commission, it was pointed out that: "This case presents none of the complications which may arise in determining who, if anyone, may bring actions under § 10 (b) and Rule 10b-5." (393 U.S. at 467 n. 9)

known"* of some corporate misstatement or omission and are liable for monetary damages under Section 10(b) for not causing corporate reports and releases to state the facts which are now asserted to be correct. Whether such damage liability should be imposed against defendants who have not purchased or sold any securities and who are not even alleged to have made any misstatement in connection with any sale or purchase of securities by themselves or anybody affiliated with them, whether problems of disclosure enforcement suggested in the Solicitor General's memorandum are in fact adequately dealt with under existing law and Commission rules as the Wheat Report concludes, or whether amendment of the securities laws is the answer as suggested in Mr. Milton H. Cohen's recent article, *"Truth in Securities Revisited"*, 79 Harv. L. Rev. 1340, 1369-70 (1966), are aspects of the question presented by the petition here.

As this Court recently noted in the first and only Section 10(b) case to come before it, "§ 10(b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws", *Securities and Exchange Commission* v. *National Securities, Inc., supra,* 393 U.S. at 465 (1969). We respectfully submit that this is the appropriate occasion and case for this Court to review the direction which the lower courts, heretofore without this Court's guidance, are taking in the construction and application of Section 10(b) and Rule 10b-5 and to define the proper scope and application of the Section and Rule.

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* While the decision below and the Solicitor General's memorandum focus on the word "knew", thereby attempting to avoid the additional "troublesome question" of whether or not liability for damages in negligence exists under 10(b), it is apparent that these and other pending cases are proceeding to trial, at least as to most defendants, with at best a hope by the plaintiffs of showing negligence.

CONCLUSION

The writ of certiorari should issue.

Respectfully submitted,

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